their interpretations of the bankruptcy code in light of the unique aims of bankruptcy law,[15] and AT&T has not explained why those interpretations are relevant here.

If anything, bankruptcy precedent strongly suggests that an option similar to NewCo's would be regarded as neither an "equity interest" nor conferring "ownership." A warrant issued by a debtor in bankruptcy is *not* an "equity security" for bankruptcy purposes where the warrant is invalid before court approval because such a warrant "until approved . . . constitutes no more than a *prospective* warrant which is insufficient to satisfy the definitional requirements for an 'equity security.'" *In re Daig Corp.*, 48 B.R. 121, 132 (Bankr. D. Minn. 1985) (emphasis added). Moreover, under bankruptcy law, even a share of common stock is deemed to lack "all the indicia of ownership" and its holder considered not to be an "owne[r]" of "equity" where the stock is stripped of voting rights and the instrument is not freely transferable. *In re Motels of America, Inc.*, 146 B.R. 542, 544 (Bankr. D. Del. 1992). Under these cases, NewCo's conversion rights would not be an equity security because those rights allow NewCo to acquire more than a 10 percent interest in Genuity

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[15] *See, e.g.*, *Allen v. Levey*, 226 B.R. 857, 862 (Bankr. N.D. Ill. 1998) (holding that equity security interest should be defined broadly when determining bankruptcy estate due to purpose of Act) (cited by AT&T); *In re Eastern Maine Elec. Coop., Inc.*, 121 B.R. 917, 929 (Bankr. D. Maine 1990) (holding that because bankruptcy code is unique, the definitions it contains must be read in light of the particular "statutory and factual terrain" of bankruptcy).

Interestingly, for all of AT&T's talk about "uniform" treatment of options across the securities and bankruptcy contexts, Opposition at 19, bankruptcy courts have specifically concluded that there is no necessary overlap between the definition of the term "equity security" in the securities laws and the bankruptcy code. *See In re Eastern Maine Elec. Coop., Inc.*, 121 B.R. at 930 ("Thus, notwithstanding the broad definition of 'security' under the securities acts, the limits of the term as heretofore defined may well be inadequate to the task set by the Bankruptcy Code."); *see also id.* at 929-932 (holding that definition of "equity security" in securities law was not the same as definition in bankruptcy law). And AT&T concedes that the bankruptcy code does not treat convertible debt as equity, even though the securities laws do, see Coffee Decl. ¶ 15, because of the bankruptcy-specific policy of not wanting "the debt holder to lose the priority status to which it is entitled." Opposition at 18 n.16 (citing authorities).

only after the elimination of all applicable 271 restrictions and is transferrable only after NewCo meets the 50 percent 271 threshold.

Financial Accounting. AT&T's reliance on accounting principles for the proposition that an option is an equity interest, *see* AT&T May 5 Opposition at 9, 18 n.17, is wholly misplaced. Although AT&T is correct that the Financial Accounting Standards Board ("FASB") in *some* instances treats options like common stock, it omits the fact that this occasional treatment of options is motivated solely by the particular goals of accounting, which are irrelevant here. Indeed, in the very opinion relied on by AT&T, the FASB expressly provides that its decision occasionally to treat options as common stock is limited to the calculation of a *single* piece of data and is not a generally applicable rule *even for accounting purposes*. *See* FASB, Accounting Standard, Accounting Principles Board, Opinion No. 15, ¶ 39 (rel. 1969) ("The designation of securities as common stock equivalents in this section *is solely for the purpose of determining primary earnings per share*. No changes from present practices are recommended in the accounting for such securities.").[16] In addition, the FASB opinion cited by AT&T, by implication, proves that options are *not* equivalent to shares. By expressly providing that in some instances options should be "*regarded as*" common stock, the opinion implicitly recognizes that options generally are *not* equivalent to stock.

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[16] In the opinion AT&T cites, the FASB explains that options should be "*regardedas* common stock" for the purpose of calculating a company's earnings per share (which is determined by dividing a company's net income by the number of outstanding shares) to avoid over-inflation of the data caused by failing to take into account the options that might be converted into shares in the future (and thereby increase the denominator in the aforementioned equation). *Id.* ¶¶ 1-3, 15. Accordingly, the cited FASB opinion instructs companies to include in their financial statements an estimate of earnings per share that "regards options as common stock" – this is referred to as a "fully diluted" earnings per share estimate. Potential investors reviewing the financial statement of a company can therefore know the upper and lower limits of the company's earnings per share. *See id.* ¶ 40.

What is more, AT&T disregards the fact that the FASB opinion it cites has been superseded by a later FASB statement. And under the current rule, NewCo's option here would *not* be regarded as common stock or its equivalent. In Statement of Financial Accounting Standards No. 128 ("SFAS No. 128"), the FASB amended the opinion AT&T cites to provide that, when a right to convert an option into stock is contingent upon some future event, the option is *not* regarded as common stock until that event occurs. *See* SAFS No. 128 ¶¶ 30, 34, 35 (Feb. 1997). Under this rule, NewCo's option would not be regarded as common stock in DataCo, even for the limited accounting purpose of calculating fully diluted earnings per share, *unless and until* NewCo first satisfies contingencies that are a prerequisite to the exercise of the option. *See id.* Furthermore, under current generally accepted accounting purposes, *even after* NewCo crosses the 50% section 271 threshold, but before conversion, the conversion right is treated only as a "potential common share outstanding" in the calculation of diluted earnings per share. Id. at ¶ 35. Accordingly, current accounting practices further confirm that the option here is not an equity interest.

Derivative Suits. While AT&T is correct that some "federal courts have also held that option holders may bring derivative suits" like shareholders, Opposition at 18, AT&T fails to mention that the holdings it relies on constitute the decisive minority rule. Indeed, the two cases AT&T cites for this point appear to be the *only* two such cases. On the other side of the ledger, however, are numerous cases holding that only ownership of shares confers standing to pursue a derivative suit:

> The timber of sound reason forms the conceptual underpinning of the rule requiring stock ownership in a corporation as the prerequisite for bringing a derivative action in its behalf. Only by virtue of the shareholder's interest, which has been described as a proprietary interest in the corporate enterprise which is subject to injury through breaches of trust or duty on the part of the directors, does equity permit him to step into the corporation shoes and seek in its right the restitution he could not demand on his own. Standing is justified only by this proprietary interest created by the stockholder relationship and the possible indirect benefits the nominal plaintiff may

> acquire qua stockholder of the corporation which is the real party in interest. Without this relationship, there can be no standing, no right in himself to prosecute this suit.

Kauffman v. Dreyfus Fund, Inc., 434 F.2d 727, 735 (3d Cir. 1970) (citations omitted). The same rule applies to the holders of convertible securities.[17] Consistent with these rules, an overwhelming majority of courts have held that the holder of a convertible security is owed no fiduciary duty by the directors and officers of the corporation.[18] Once again, these cases demonstrate that corporate

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[17] *See Kusner v. First Pennsylvania Corp.*, 395 F. Supp. 276, 282 (E.D. Pa. 1975), *rev'd on other grounds*, 531 F.2d 1234 (3rd Cir. 1976) ("the concept of proprietary interest is distorted beyond analytical usefulness when the holder of a mere option to purchase shares who has not yet exercised his option or legally committed himself to the exercise of his option is held a shareholder under Rule 23.1."); *Harff v. Kerkorian*, 324 A.2d 215, 219 (Del. Ch. 1974) ("the conclusion is inescapable that plaintiffs [holders of convertible debentures] are creditors of MGM and simply do not have standing to maintain a stockholder's derivative action."); *Kessler v. General Cable Corp.*, 92 Cal. App. 3d 531, 540 (Cal. Ct. App. 1979) ("The view remains, generally, that holders of debentures, with an option to convert, remain corporate creditors only, without any special status which affords them the opportunity to litigate in the area of potential damage to their economic interests.") (citing *Helvering v. Southwest Corp.*, 315 U.S. 194 (1942); *Levine v. Chesapeake & O.R. Co.*, 60 A.D.2d 246 (N.Y. 1977)); *Brooks v. Weiser*, 57 F.R.D. 491, 494 (S.D.N.Y. 1972) ("The fact that among the plethora of derivative suits brought over the generations none even discusses the issue (of whether or not creditors are entitled to sue on behalf of the debtor corporation) reflects the obviousness of the proposition that the right to sue derivatively is an attribute of ownership, justified on the theory that the plaintiff in such a suit seeks to recover what belongs to the corporation, because as a co-owner, it also belongs to him."); *Dorfman v. Chemical Bank*, 56 F.R.D. 363 (S.D.N.Y. 1972) (plaintiff was debenture holder; held insufficient interest to bring derivative suit).

[18] *Glinert v. Wickes Cos.*, No. 10407, 1990 WL 34703, *9 (Del. Ch. Mar. 27, 1990) ("Under our law, the option feature of these instruments does not qualify for the protections that flow from a fiduciary duty. Our prior cases have held that an option to buy stock in futuro does not make one an equitable stockholder."), *aff'd*, 586 A.2d 1201 (Del. 1990); *Powers v. British Vita, P.L.C.*, 969 F. Supp. 4, 6 (S.D.N.Y. 1997) ("Clearly, any attempt to analogize options to stocks in order to suggest a fiduciary duty are to no avail."); *Simons v. Cogan*, 549 A.2d 300, 303-04 (Del. 1988) ("a mere expectancy interest does not create a fiduciary relationship. Before a fiduciary duty arises, an existing property right or equitable interest supporting such a duty must exist. The obvious example is stock ownership. Until the debenture is converted into stock, the convertible debenture holder acquires no equitable interest and remains a creditor of the corporation whose interests are protected by the contractual terms of the indenture."); *Anadarko Petroleum Corp. v. Panhandle Eastern Corp.*, 545 A.2d 1171 (Del. 1988) (holding same); *Starkman v. Warner Communications, Inc.*, 671 F. Supp. 297, 304 (S.D.N.Y. 1987) ("The [option] instrument stands alone, claiming no equity in the corporation, entitled to no vote, and with no fiduciary obligation of the management to the optionholder's interest."); 18A Am. Jur. § 565 (1985) ("corporate directors owe no duty to consider the interests of debenture holders in determining the price for converting debentures into stock.").

law draws a fundamental distinction between equity owners on the one hand and option or convertible security holders on the other.

American Law Institute. AT&T's reliance on the American Law Institute's Principles of Corporate Governance ("ALI Principles") is equally misplaced. At the outset, AT&T blatantly mischaracterizes these principles as a "restatement" of the law. *See* Opposition at 19. Since the inception of the ALI, its members have debated whether to produce a restatement on the law of corporations and have repeatedly voted *against* issuing a restatement. *See* ALI Principles, President's Foreword. The current version of the ALI Principles is *not* a statement of current law and does not even purport to be a restatement of the law. Instead, it forms the "recommendations" and the "Institute's views" of what the law *should* be. *See id.*; Gilson Third Supp. Decl. ¶ 8 n. 1. Indeed, as the President of the ALI observes: "There will never be a time when the work is done and its results labelled 'A Complete Restatement of the Law.'" *See* ALI Principles, President's Foreword. In other words, the ALI Principles are a consciously aspirational and prescriptive project of law professors, *not* a descriptive codification of what *courts* hold the law to be. In particular, the definitional provision that AT&T quotes (section 1.19) is based on no legal authorities, but is "new" and was "promulgated" by the ALI itself for purposes of its own project. *See* § 1.19 Comment & n.a. AT&T knows this; it is for this reason that it puts the word "restatement" in quotes. *See* Opposition at 19.

In any event, not even the ALI aspires to treat options as equity interests. As explained by Professor Gilson (one of the reporters for the ALI Principles), the ALI's definition of equity interests that AT&T quotes includes *only* the underlying security that composes a convertible security. *See* ALI Principles §§ 1.19, 1.20. With respect to the option itself, the instrument at issue in this case, the ALI notably takes no position as to whether the option is an equity interest. *See id.* Indeed, this lack of a position is evident in the comments accompanying section 7.02 of the ALI Principles. Section 7.02 concerns standing to bring derivative suits. It provides that holders of "an equity security" have such standing. *See* ALI Principles § 7.02(a). The comments explaining this provision, however, expressly state that "Section 7.02(a) takes no position on whether the holder of a warrant or right issued by the corporation and not attached to some other security should have standing to bring a derivative action." *See id.* § 7.02(a) Comment. If, as AT&T suggests, an option is an "equity security" (and thus an "equity interest") under the ALI Principles, then 7.02 could *not* fail to take a position on this issue; such holders would have standing by the terms of the rule. *See* Gilson Third Supp. Decl. ¶ 8. While the NewCo Class B shares clearly represent a 9.5 percent equity interest in Genuity, at issue here is whether the separate option is an *additional* equity interest. On this question, the ALI Principles explicitly disclaim that they are. *Id.*

But even if AT&T's reading of the ALI principles were correct, it would not be persuasive evidence of the meaning of "equity interest" here. Sections 3(1) and 271 are concerned with *current ownership interests*. *Nothing* in the definitional provisions or anywhere else in the ALI Principles, however, suggests that options, or other conversion right are *current* ownership interests. Moreover, the only general statement of corporate law that addresses this issue, the Model Business Corporations Act, provides that options cannot be characterized as current ownership. *See* Model Business Corporations Act § 7.40(2) (defining "shareholder" to include "a beneficial owner" of shares); *Id.* § 7.41 Official Comment (observing that "holders of options, warrants or conversion rights" are not shareholders under this definition).

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At the end of the day, AT&T's cited authorities do not support its categorical position. Nor is this surprising: not even AT&T consistently subscribes to the unrealistic position it has advocated in these proceedings. For example, in a brief to the D.C. Circuit defending Judge Greene's order requiring the Bell companies to disclose to the Justice Department any options they held in prohibited companies, AT&T argued that an option was not an "actual equity interest."[19] Similarly, within the last year, AT&T represented to the Commission that options are not ownership by omitting any reference to MediaOne's option to acquire an additional interest in Time Warner Entertainment ("TWE") in describing MediaOne's "ownership interest" in TWE in its official filings. Bell Atlantic/GTE March 14 Ex Parte at 4 n.2. And even AT&T's expert, Professor Coffee – in the course of filing another affidavit in support of AT&T – has used the phrase "equity interest" to refer to a present stock interest but not an option. Specifically, in an affidavit filed with Judge Greene in support of AT&T's request for a waiver in connection with its acquisition of McCaw Cellular, Professor Coffee described McCaw's subsidiary, LIN Cellular Communications Corp., as an entity "in which McCaw holds a 52% equity interest and an option to acquire the remaining equity." Affidavit of Professor John C. Coffee, Jr., at 9, *United States v. Western Elec. Co.*, No. 82-0192 (D.D.C. filed May 24, 1994). *See also* AT&T's Motion for a Waiver of Section I(D), at 8, *United States v. Western Elec. Co.*, No. 82-0192 (D.D.C. filed June 7, 1994) (describing LIN as only

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[19] Brief of AT&T, *United States v. Western Elec. Co.*, No. 86-5641, at 14-15 (D.C. Cir. filed June 26, 1989). Specifically, AT&T defended Judge Greene's decision, which concluded that some options were prohibited by the consent decree's broader definition of "affiliated enterprise," as follows:

> For example, what if an RHC secretly paid a billion dollars for a long-term transferrable option to purchase 100% of a major manufacturer at a nominal price. * * * The RHC could then sell the option and profit from the manufacturing business, without ever seeking a waiver. * * * [T]he very conduct the Decree sought to end would occur for years, ***without an RHC ever owning an actual equity interest*** in the manufacturer . . . ."

Id. at 14-15 (emphasis added).

"52%-owned" by McCaw, notwithstanding the option to acquire its remaining equity). In sum, neither AT&T nor its faithful expert appears to believe in the absolutist position that options are necessarily "equity interests" or "ownership."

2. NewCo Will Not Own The "Equivalent" Of A Forbidden Equity Interest In Genuity.

NewCo's conversion right will not amount to the "equivalent" of a prohibited "equity interest" in Genuity. The word "equivalent" in section 3(1) is not a word of uniform fixed meaning. Judge Stephen Williams, for example, in construing an MFJ-era consent decree that contained an almost identical definition of the term "affiliate," concluded that the meaning of the very same words "the equivalent thereof" in the phrase "equity interest (or the equivalent thereof)" was "not clear."[20] But whether under a strict interpretation of the term or a more flexible one, NewCo's option would not be the "equivalent" of an equity interest.

A strict interpretation readily excludes NewCo's option. Because "equity interests" are defined in terms of legal participation rights, the "equivalent" language of section 3(1) should similarly refer to those arrangements that confer the same (or very similar) participation rights as equity interests. For example, a device would be the "equivalent" of an equity interest if it conferred the three participation rights through contract rather than through a more traditional capital structure investment. *See* Gilson Second Supp. Decl. ¶ 11. Equity "equivalents" would also include instruments that are not styled as common stock, or that may even lack voting rights, but that nevertheless carry the other traditional distribution and liquidation rights of equity ownership. *See* Gilson Decl. ¶ 18 ("[I]n appropriate circumstances partnership interests, debt interests that confer

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[20] *United States v. Western Elec. Co.*, 12 F.3d 225, 239 (D.C. Cir. 1993) (Williams, J., dissenting) (point not disputed by majority).

the right to participate in earnings rather than receive simple interest, and nonvoting preferred stock that also participates in earnings as well as receiving a fixed dividend, may serve as equity equivalents."). But NewCo's conversion right is not an equity "equivalent" under this straightforward construction for the same reason it is not an "equity interest": it confers *none* of the three traditional indicia of equity ownership.

If the Commission gives "equivalent" a more flexible meaning, AT&T's position still fails. The crux of AT&T's arguments is that the Class B option is the "equivalent" of an "equity interest" of 80 percent of Genuity because the Class B shares would be valued by the market at somewhere near 80 percent of the value of Genuity. This entire argument flows from AT&T's original reliance on Black's Law Dictionary to define "equivalent" as meaning "equal in value." *See* AT&T March 10 Ex Parte at 3 ("Two things are 'equivalent,' of course, if they are equal in value.") (citing Black's Law Dictionary (7th ed. 1999)). But while this is doubtless a linguistically permissible definition of "equivalent," it is by no means the only permissible one. Indeed, the complete definition upon which AT&T relies defines "equivalent" to mean "equal in value, force, amount, effect, or significance." NewCo's conversion right would not be the equivalent of an "equity interest" measured along several of these axes: the Class B shares lack the "force," "effect," and "significance" of stock because they lack rights to vote and participate in distributions. In fact, and consistent with the strict interpretation discussed above, the edition of AT&T's dictionary of choice that was current when the 1996 Act was written defined "equivalent" as "equal in value, force, measure, volume, power, *and* effect or having equal or corresponding import, meaning or significance." Black's Law Dictionary (6th ed. 1990). Under that definition, our Class B shares could never be the "equivalent" of an equity interest because they do not confer any participation rights, and therefore the "force," "power," and "effect," of traditional common stock.

Under a more flexible interpretation, "equivalent" is a term whose application necessarily depends on the policies relevant to the context in which it is applied. *Cf. American Broadcasting Co. v. FCC*, 663 F.2d 133, 138-39 (D.C. Cir. 1980) ("functional equivalency" standard for "like communications service" under section 202). The question is, "equivalent" for what purpose? Thus, notwithstanding AT&T's suggestion, it is entirely proper for the Commission to apply "equivalent" based on the purposes and policies of section 271. Indeed, it would be improper for the Commission, like AT&T, to place "sole reliance on a dictionary definition to find plain meaning [because that would] 'reflec[t] . . . no assessment of statutory objectives, no weighing of congressional policy, [and] no application of expertise in telecommunications.'" *In the Matter of AT&T Corp. v. Ameritech Corp.*, 13 FCC Rcd 21438, ¶ 27 n.108 (quoting *Alarm Monitoring Communications Comm. v. FCC*, 131 F.3d 1066, 1069 (D.C. Cir. 1997) (reversing Commission's interpretation of statutory term based entirely on a dictionary definition)).

Under this approach, the Class B conversion right is not an "equivalent," not only because it lacks the requisite participation rights, but also because it does not threaten, and indeed it even furthers, the statutory purpose of prohibiting the provision of in-region interLATA service without Commission approval. As we have described before, and as we reiterate below, our specific transaction affirmatively promotes the policies of 271 for several distinct reasons. Bell Atlantic/GTE April 3, 2000 filing, at 13-16.[21] The direct effect of our proposal is to increase the net incentives of

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[21] Although AT&T still asserts that the Commission cannot look to the policies of section 271 because the definition of "affiliate" appears in section 3(1), it has simply ignored our prior refutation of this point. *See* Bell Atlantic/GTE, April 3 Filing at 13 n.21.

NewCo to complete the 271 process as soon as possible. Genuity is a unique asset, and the ultimate ability to reacquire ownership and control over it is the driving force behind NewCo's national data strategy. Furthermore, the risk to NewCo of losing Genuity forever by failing to achieve interLATA relief and of losing its initial investment in Genuity will also create a much bigger incentive for NewCo's continued progress in the 271 process. There is also no significant risk of discrimination to weigh against these benefits because, as a practical matter, discrimination by NewCo in favor of Genuity is highly implausible and would be readily detectable. *See* Declaration of Raymond F. Albers (filed Feb. 22, 2000) (attached to our Response). And while our interpretation prevents circumvention of 271's prohibition against the provision of in-region interLATA service without Commission approval, it simultaneously excludes instruments whose inclusion would serve no statutory purpose.

In contrast, AT&T's reliance on mere value equivalence would broaden the definition of "affiliate" so as to make "equity interest" meaningless. For example, under AT&T's definition of "equivalent," the Commission would be without discretion to conclude that the holder of a corporate bond valued at 10.1 percent of the company was not the owner of that company. Indeed, under AT&T's definition, \$100 in cash is equivalent to a share of common stock that trades at \$100. While such a definition of "equivalent" may be helpful in other theoretical contexts, it is useless here.

AT&T also advances two additional reasons why, in its view, NewCo's right to obtain an equity interest in Genuity in the future should be deemed the "equivalent" of current equity ownership. As we discuss below, neither of these arguments has any merit.

Appreciation. The fact that NewCo can, after eliminating all applicable 271 restrictions and after the ultimate exercise of its full conversion rights, realize the appreciation in value of Genuity does not make those conversion rights the equivalent of current equity ownership. AT&T's argument to the contrary rests on an economic and legal fallacy that equates the right to share in appreciation of an asset with ownership of that asset. The right to appreciation can be obtained through a bet on a corporation with a derivative, such as an option, without any dealing with the corporation at all, let alone ownership. "The right to participate in the appreciation in the value of a corporation is not, by itself, an equity interest or its equivalent since securing the opportunity to share in this appreciation can be accomplished through derivative products that plainly are not equity interests under corporate law." Gilson Decl. ¶ 15. For example, GTE could sell Genuity today in exchange for cash, and purchase with that cash a proprietary derivative from Goldman Sachs whose value would appreciate by the same amount as that of Genuity. In that hypothetical, GTE would clearly not be an owner of or hold an equity interest in Genuity even though it would have secured the same right to share in its appreciation in value as if it owned Genuity all along. The point is that the fact that NewCo may share in the appreciation in Genuity's value does not render NewCo an owner or the equivalent thereof.

If the rule were otherwise, then any fixed-price option to purchase a company would necessarily constitute what AT&T calls "retroactive" ownership of that company after exercise of the option. Any fixed price option by its very nature allows its holder to capture the appreciation of the optioned asset upon exercise. In the typical case, the option holder pays a premium in advance for the right to purchase an asset within a specified time in the future at a pre-negotiated and fixed strike price. If the value of the optioned asset increases or remains above the strike price, the option holder will exercise the option, purchase the asset, and share in the appreciation to the extent of the difference between the strike price and the market price at the time of exercise. Thus, AT&T is really arguing that the Commission must regard all fixed-price options as *per se* ownership.

AT&T's argument, if accepted, would also prohibit any fixed-price merger of a BOC and another company owning an interLATA business even if the interLATA business were entirely divested before closing. In the case of an executory merger contract, so long as the price that the BOC pays for the other company is fixed in the merger contract, the BOC upon closing of the merger will capture all of the appreciation of the interLATA business that accrued between the signing of the contract and the divestiture. The Commission, however, has not succumbed to this fallacy. For example, as recently as March 2000, the Commission approved the U S WEST/Qwest merger conditioned on Qwest's divestiture of interLATA assets.[22] If the ability to share in the appreciation of an asset were the equivalent of ownership, then upon closing of the U S WEST/Qwest merger, U S WEST will illegally receive the same "right retroactively to obtain profits from *prior years*" that AT&T accuses us of securing. Opposition at 24.

In any event, even though appreciation is not, as AT&T says, a "fundamental aspect of equity," Opposition at 22, we have nonetheless modified our proposal so that NewCo will not share in any of Genuity's unique appreciation above NewCo's 10 percent equity interest in the event of a sale of NewCo's option. This voluntary undertaking forgoes all Genuity-specific appreciation in the event that NewCo does not obtain 271 approval, and it further enhances NewCo's incentives to

[22] *See Qwest Communications Int'l, Inc. and US WEST, Inc., Applications for Transfer of Control of Domestic and International Sections 214 and 310 Authorizations and Application to Transfer Control of a Submarine Cable Landing License*, Memorandum Op. and Order, CC Docket No. 99-272, 2000 WL 263685 (March 10, 2000).

comply with 271 because NewCo's ability to earn a rate of return on its initial investment above the S&P 500 will depend upon eliminating 95% of its applicable 271 restrictions.[23]

Risk and Cost. AT&T also suggests that NewCo's option must be the "equivalent" of an "equity interest" because, according to AT&T, it does not bear risk and is costless. This would be wrong even if its premises were accurate. The conversion right, until exercised, conveys no participatory rights that are characteristic of equity, and the restriction on exercise makes it anything but the equivalent of an equity interest.

But AT&T's premises were demonstrably false under our old proposal, and they are even more so in light of our recent modifications. Under our original proposal, we placed at risk a real opportunity by purchasing a conversion right rather then selling all of Genuity's assets in exchange for cash and investing that cash in something else. Neither was our original proposal costless: in exchange for the conversion right, GTE was surrendering 90 percent of the value of Genuity.

Our April 28 modifications introduced even more risk and cost into the equation. We have now placed entirely at risk both our opportunity cost as well as 90 percent of the current value of Genuity. If NewCo does not secure 271 approval on more than 50 percent of Bell Atlantic's lines, NewCo's ability to acquire more than 10 percent will expire worthless. Nor can NewCo avoid this risk by selling the conversion right to a third party for value. Until the 50 percent threshold is reached, NewCo cannot sell an option to acquire more than 10 percent of Genuity's stock, and until the 95 percent threshold is reached, NewCo's proceeds from a sale of the option to acquire more than

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[23] As for AT&T's suggestion that this penalty is not genuine because Genuity may underperform the S&P 500, AT&T has once again changed course: After having argued for months that NewCo should not be permitted to share in the special appreciation associated with Genuity's interLATA business, it now argues that Genuity is a bad investment. This lacks credibility.

10 percent of Genuity's stock are limited to the value of its initial investment (with its return capped by the S&P 500 Index). Thus, under our modified proposal, (i) NewCo has placed its entire option premium at risk, (ii) there is now a genuine possibility that neither NewCo nor anyone else will be able to exercise the option to acquire more than 10 percent of Genuity, and (iii) NewCo cannot even sell the option to a third-party until a significant contingency has occurred.

AT&T nevertheless insists that these modifications do not introduce any genuine risk because obtaining 271 approval turns "exclusively upon behavior in [NewCo's] control." Opposition at 11. This is nonsense. The exercise of any option turns on behavior in the control of the option holder: the holder decides whether to exercise. What matters is that NewCo cannot guarantee that it will secure the requisite 271 relief within the conversion period. The 271 approval process is not entirely within NewCo's control. It is disingenuous for AT&T to argue that we face *no* contingency in obtaining 271 approval for over 50 percent of Bell Atlantic's lines simply because we are highly motivated to do so. Indeed, it is perverse to argue that NewCo would *violate* 271 simply because it is likely to secure 271 compliance. Moreover, AT&T's argument ignores the practical reality of how difficult and enormously costly it is for a Bell company to make all the changes necessary to secure 271 approval. It also ignores the additional contingencies introduced into the 271 process by changing technology, such as the introduction of new interconnection and unbundling requirements that are specifically tailored to DSL providers. Under our proposal, NewCo will place at real risk the lion's share of GTE's entire initial investment in Genuity.[24]

[24] AT&T belittles the fact that reaching the 50 percent threshold would "merely" require achieving 271 approvals in two more of the large Bell Atlantic states. Opposition at 12 n.11. It is by no means a legal certainty that NewCo will achieve those necessary approvals within five years, considering that only one Bell company has achieved only one 271 approval in more than four years since enactment of the Telecommunications Act of 1996.

Nor is our option to obtain an interest in Genuity in the future costless. NewCo is paying for the option in-kind with 90 percent of Genuity – assets that are now highly valuable and owned by GTE. No cited authority supports AT&T's implicit argument that an option or other conversion right is a "sham" if it is pre-paid. Indeed, in any convertible security, the exercise price is pre-paid, yet such convertible securities are routinely treated as *not* current equity ownership, as demonstrated above. Moreover, one of the important MFJ precedents involved an option that could be exercised at a "nominal price." See Bell Atlantic/GTE Supplemental Filing, at 43 (discussing SBC case). As a legal and economic matter, it should make little difference whether we pay for our conversion rights in advance or upon exercise. The price today of an option or other conversion right to obtain 70 percent of Genuity will simply reflect 70 percent of the expected net present value of Genuity. That is precisely what we are paying for the option, although under our proposal we are paying in kind and up front by surrendering 90 percent of GTE's current ownership in Genuity. The Commission should, in fact, *favor* pre-payment because it *increases* NewCo's incentives to comply with 271 by making it more costly for NewCo to walk away from the 271 process than it would be if NewCo deferred payment for the additional 70 percent of Genuity until exercise.

B. NewCo Will Not Control Genuity Before It May Lawfully Do So.

Reflecting yet another major course reversal, AT&T's May 5 Opposition focuses primarily on ownership and places much less emphasis on the question of control than did AT&T's earlier submissions. That is not surprising. We had largely eliminated any control issue with our April 3 filing, and the modifications to the board selection process and investor safeguards that we outlined in our April 28 submission (and clarify in Appendix D today) only further confirm that NewCo will have no improper control over Genuity's business pending 271 relief.

As we have previously pointed out (and AT&T has conceded), control is a fact-specific and context-specific inquiry. *See* Bell Atlantic/GTE April 3 Filing at 16 (citing AT&T filings). The Commission has extensive experience evaluating questions of control in many different commercial contexts and under various statutory and regulatory regimes. Typically, the Commission applies its "totality of the circumstances" approach to control, *see* Coffee Decl. ¶ 9, in light of the underlying purposes of the particular regulatory regime at issue. In other words, to determine whether one entity exercises cognizable or impermissible "control" over another, the Commission ordinarily examines the purposes for which the control test is being applied.

Here, the purpose of the control inquiry in the context of sections 3(1) and 271 is to ensure that a Bell company is not *providing* prohibited in-region interLATA services through another company by virtue of its control over that company. Thus, the concept of control that is significant for purposes of the 271 restriction is such control as will enable the BOC to benefit from the combined provision of both local and long distance services within its region. *See AT&T Corp. v. Ameritech Corp.*, 13 FCC Rcd 21438, ¶¶ 5, 36-37 (1998).

NewCo will have no such prohibited control over Genuity's provision of interLATA services. First, the public shareholders, not NewCo, will have 90 percent voting control over Genuity and its management. Second, Genuity will be run by an independent board – including 11 of 13 members who are outside directors with no prior relationship with GTE or Bell Atlantic. Our modified April 28 proposal now ensures that *within 90 days following the IPO*, a majority of Genuity's board will have been selected after the IPO (not installed at the outset by GTE or Bell Atlantic), and within nine months, all members of the board other than the lone Class B director will have been elected by the public shareholders. Third, Genuity's board and its officers will owe fiduciary duties to the public shareholders. Fourth, the incentive compensation for Genuity's managers will be keyed to the performance of Genuity, not NewCo. And fifth, NewCo's commercial relations with Genuity will all be contractually specified.[25]

Moreover, although the investor safeguards we originally proposed were well supported by Commission precedents holding that such protections (taken together) do not constitute control, our modified proposal pares these safeguards back even further. It is now manifestly clear that over the course of the next five years, Genuity will be able to carry out its entire business plan (as described in its registration statement) without once seeking the consent of NewCo under these investor safeguards. *See* Declaration of Paul R. Gudonis ¶ 2 ("These investor safeguards will not impede in any way the implementation of Genuity's five-year business plan. Neither a vote of NewCo's Class B shares nor NewCo's consent will be required to implement Genuity's five-year business plan in full."). In addition, we have now significantly increased the percentage vote that may be held by a single Class A shareholder to 20 percent (more than twice the vote held by NewCo). Finally, we have stipulated in our modified proposal that if NewCo were to enter into commercial loan

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[25] Covad claims that the transitional services contracts between NewCo and Genuity will have NewCo "performing nearly every single task necessary for the operation of Genuity," and that these contracts are "extendable indefinitely by the parties." Comments of Covad Communications Company at 12 (May 5, 2000). Covad is misinformed. These contracts only encompass those services that are necessary to allow Genuity to achieve viability and independence through a reasonable transition away from GTE's centralized systems. They are all for terms of no more than one year and may be terminated at any time by Genuity without penalty. *See* Declaration of Paul R. Gudonis ¶ 3 ("These contracts include a number of features that ensure Genuity's complete independence from NewCo; indeed, these temporary contracts are essential to Genuity's ability to operate as a viable independent business during its transition away from reliance on GTE[.]"). Further, contrary to Covad's assertion, under our modified proposal of April 28, as clarified by the Revised Exhibit A attached hereto as Appendix D, these contracts may only be renewed by the parties if NewCo gives the Commission 60 days notice of the intent to renew, and the Chief of the Common Carrier Bureau does not first object to the renewal. Thus, as Genuity's CEO concludes, the "cumulative effect of these factors, along with the fiduciary duty Genuity's Board owes to its public shareholders, ensures that Genuity will switch providers of these contractually specified services if doing so would give Genuity a better deal." *Id.*

agreements with Genuity, it could provide no more than 25 percent of the aggregate debt financing that Genuity may incur in the period before NewCo exercises its conversion rights.

AT&T's principal argument on control is that the simple existence of these conversion rights will cause Genuity's officers to act at the behest of NewCo. But NewCo's thoroughly independent board, which will owe its fiduciary duties to the public shareholders, nullifies any such hypothetical concern. Furthermore, our new option structure, which requires NewCo to satisfy the 50 percent 271 threshold before it has any right at all to convert into a greater than 10 percent interest, also significantly weakens AT&T's argument, since there is now a genuine possibility that NewCo will never be in a position to exercise its option to take control of Genuity. This possibility renders even more tenuous the notion that NewCo could somehow exercise indirect control over Genuity's management by virtue of the expectation that NewCo will ultimately own the company.

For all these reasons, NewCo will clearly not exercise impermissible control over Genuity pending 271 relief.

C. Our Proposal Is Consistent With, and Indeed Advances, the Purposes of Section 271.

Finally, our proposal, especially as modified, is not only fully consistent with the purposes of section 271, but it positively furthers those purposes. It will create a powerful new net incentive for NewCo to complete the 271 process as rapidly as possible in all of its in-region states in order to exercise its conversion rights and take ownership of Genuity. *See In re Qwest Communications Int'l, Inc. and U S WEST, Inc.*, CC Docket No. 99-272, ¶ 2 (rel. Mar. 10, 2000) (recognizing that Qwest/U S WEST will have "powerful new incentives" to comply with section 271 to realize the maximum integrated value of Qwest's national network). Moreover, the very substantial risk to

NewCo of losing Genuity forever if it fails to achieve 271 relief will also create a much bigger "stick" to spur 271 compliance.

Our April 28 modification dramatically enlarges this downside risk: If NewCo fails to satisfy the 50 percent 271 threshold within the conversion period, it will totally lose any ability to get back the value of GTE's original investment in Genuity – a several billion dollar loss. And beyond the 50 percent threshold, the only way NewCo can realize the full and unique value of that investment over and above the standardized S&P 500 cap is to push forward as quickly as possible and attain at least 95 percent 271 relief. These requirements create even more powerful mechanisms than section 271 alone provides to compel compliance with the market opening provisions of the Communications Act.

Taken as a whole, then, the Bell Atlantic/GTE merger, as conditioned by our proposed solution for the Genuity interLATA issues, will strongly serve the public interest and the specific goals of section 271.

CONCLUSION

The Commission should promptly grant the requested license transfer applications.

Respectfully submitted,

WPBarr

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May 9, 2000

CERTIFICATE OF SERVICE

I hereby certify that on this 9th day of May 2000, I served copies of the foregoing Response of Bell Atlantic and GTE in Support of Proposal To Transfer GTE Internetworking to a Separate Corporation Owned and Controlled By Public Shareholders either by hand or by mail, first-class postage prepaid, on the following:

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